all relevant factors). Any other determination is arbitrary and capricious and will not withstand judicial scrutiny. Camp v. Pitts, 411 U.S. 138 (1973).

In a D.C. Circuit case where telephone companies were challenging an FCC rulemaking on arbitary and capricious grounds, the court struck down the rulemaking because the "Commission failed to demonstrate that an adequate basis in the administrative record existed rationally to conclude that [the] revisions represented 'an improvement over the existing schedules.'" City of Brookings Municipal Telephone Co. v. F.C.C., 822 F.2d 1153, 1165 (D.C. Cir 1987). Similarly, the FCC's proposal to remove the carriers' reporting requirements and, thus, its support for its findings has the effect of removing a rational basis for the FCC's depreciation prescriptions.

These standards are based on the Administrative Procedure Act's (APA) judicial review provisions. Section 706(2)(A) of the APA requires a reviewing court to set aside an agency action if it is arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law. 5 U.S.C. § 706(2)(A). A reviewing court must satisfy itself that the FCC had examined relevant data and articulated a satisfactory explanation for its action based upon the record. California v. F.C.C., 905 F.2d 1217 (9th Cir. 1990).

Since Option Four does not require a carrier to provide any factual basis supporting its depreciation rate request, there would be no record basis for any FCC decision relevant to the carrier's depreciation rates. As a result, a reviewing court would

find the FCC's action under Option Four to be in violation of the APA as arbitrary and capricious since the agency would be unable to offer an explanation for its decision based on facts before the agency. Not only is this type of regulation (termed "[r]egulation by robots" by Commissioner Duggan in his Concurring Statement) unlawful, but it is unsound policy as well.

3. The Fourth Option Is Inconsistent With The Communications Act Notice Requirement.

SCA submit that the Commission must review the carriers' depreciation rates and provide meaningful notice in order to be consistent with the 1934 Communications Act (§ 220 (i)) which provides, in pertinent part, that:

> [t]he Commission, before prescribing any requirements as to accounts, records, or memoranda, shall notify each state commission having jurisdiction with respect to any carrier involved, and shall give reasonable opportunity to each such commission to present its views, and shall receive and consider such views and recommendations.

47 U.S.C. § 220(i) (emphasis added).

The Communications Act presents a strong commitment to the receipt of state comments before depreciation prescription may occur. As Commissioner Duggan points out in his Concurring Statement, depreciation is the largest portion of a telephone company's expense, is not a measurable out-of-pocket cost and many states currently rely on the FCC's depreciation prescriptions. Notice, Duggan St. at 2. The FCC must provide appropriate opportunity for the states to express their views and recommendations regarding carriers' depreciation prescriptions.

Option Four as proposed in the Notice does not conform to the policy underlying this requirement.

SCA are concerned with the inability of the public including state regulatory agencies and the carriers' competitors, to rationally comment on the filings under this plan in the absence of any supporting data. Option Four would simply turn the prescription process into an empty gesture. As Commissioner Duggan noted:

> Although the public would be allowed to comment on those proposed rates, they would do so in a vacuum. Their views would be virtually meaningless, because the carriers would have filed no documentation to support their chosen rates. This option, in effect, would mean that the FCC would simply rubber-stamp the carriers' proposed depreciation rates . . . .

Without any data as to the carriers' current asset lives and planned retirements, other parties would simply have nothing to comment upon. Any depreciation rates which result from this process - which would be entirely unsupported by fact - represents a poor public policy and an unlawful restriction of the comment opportunity.

4. The Fourth Option Breaks Any Link Between Depreciation Expense And Actual Modernization Of The Network.

As the telecommunications network is converted to digital electronic hardware, local exchange carriers may well experience significant future reductions in unit costs paralleling those which are being achieved in the computer industry. Under the price cap mechanism such expense reductions, and any related increases in

achieved rates of return, are no longer necessarily cause for reducing service rates. Thus, under the price cap mechanism the clear link between carrier costs and service rates no longer exists. Thus, much of the potential benefit to be derived from future lower unit costs has been lost.

Option Four would also have the impact of allowing the local exchange carriers to arbitrarily increase their depreciation expense without any consideration of underlying asset retirements. This would further thwart any price cap sharing concept while increasing carrier cash flows.

The adoption of the Fourth Option would adversely affect several aspects of regulation, including the fundamental ability to analyze supporting data, and would result in uncertain and unquantified cost savings. The risk inherent in setting depreciation expense in a way that no longer relates depreciation expense to asset consumption is great. The FCC should be extremely cautious of proposals that allow the companies to dramatically increase depreciation expense when there are no assurances that the modernization of the telecommunications infrastructure will follow.

The existing procedures provide the mechanisms to assure that if the Commission grants increased levels of depreciation the Commission will continue to track actual retirements as depreciation rates are established in the future. In this manner, the Commission continues to monitor how projections of future retirements are later matched with actual retirements. Thus, carriers are encouraged to apply such increased cash flows to

modernize their networks. In the absence of continuing Commission depreciation review, increased depreciation expense may be used simply to reward the stockholders with extra cash flow which could well be invested in other endeavors of the LECs. Option Four would allow increased depreciation expense on a long term basis even if no increased investment and retirement actually occurs.

E. The Commission Should Remove Salvage And The Cost of Removal From The Depreciation Process.

In the Notice, the FCC also asked all parties to consider eliminating the cost of removal and salvage from the depreciation process. Notice at ¶ 43. SCA conclude that salvage and removal issues should be eliminated from the depreciation process regardless of how the FCC otherwise determines the depreciation prescription process should proceed.

Current FCC practice requires issues of salvage and removal to be considered and quantified during the life of an asset as a part of the depreciation process. Some assets have a cost of removal in excess of their salvage value, i.e. negative net salvage, while others have gross salvage in excess of removal cost. The cost of negative net salvage is not expensed upon the date when this cost is realized but over a period of many years while the asset is still in use.

SCA emphasize that it is difficult to determine projected service lives given the extent to which those lives depend upon carrier deployment plans, technological developments, etc. It is even more difficult to determine what current plant items will be worth at the end of their projected economic life.

Removal of these considerations from the depreciation process also would provide the best incentives to maximize salvage value by requiring the net result of the salvage process to be reflected as a gain or loss upon retirement. Presently, salvage value is reflected over many years of depreciation rate projections. Reflecting the gain or loss actually incurred when the event takes place would best encourage carriers to realize whatever economic advantage is possible through the retirement process.

Such simplification is entirely consistent with the goals of the Notice. Much of the depreciation process discussed above is concerned with estimating the value of salvage and removal cost which will not occur for many years into the future. Removing the process of estimating the economic effect of an event occurring at the end of the asset's life would greatly simplify the prescription process.

This issue has frequently been considered before. Both the Commission and the National Association of Regulatory Utility Commissioners have debated this issue. The approaches used have varied from state to state. For example, in Pennsylvania by judicial decision the Pennsylvania Public Utility Commission is not permitted to expense the estimated cost of future removal during the life of the asset.

In the case of Penn Sheraton v. Pennsylvania Public Utility Commission, 198 Pa. Super. 618, 184 A.2d 324 (1962) the Superior Court of Pennsylvania ruled that projected negative net

salvage could not be included within depreciation expense when rates were set. The Court held on this issue as follows:

> Negative salvage attributed to existing plant is purely prospective; it is a cost which has not yet been incurred; it is uncertain when and if it will be incurred; and it is not a part of the original cost of construction of the facilities when first devoted to public service. To permit the recovery of prospective negative salvage is to permit the recovery of a total amount in excess of the original cost of construction prior to the actual expenditure of those costs . . . .
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> . . .
>
> Although prospective negative salvage is not entitled to consideration, the negative salvage actually incurred by the utility . . . is of course entitled to consideration in a rate proceeding. It is then no longer prospective but actual.

Id. at 627-628, 184 A.2d at 329. The policy discussion in that case also supports the determination that it is best to simplify the depreciation process and resolve uncertainty by reflecting such salvage and cost of removal when they have occurred.

This approach is particularly important where salvage value actually exceeds the cost of removal. SCA have concluded that recent experience indicates that positive salvage value is becoming more commonplace particularly with respect to retiring digital switching equipment. This type of equipment which is fully electronic and modular is much more reusable than older step-by-step and crossbar switching equipment, for example. Where positive salvage represents the realization of a gain on net income, it is compelling to reflect that gain for ratemaking purposes when the event occurs rather than over the life of the related asset.

Concern may also exist that the current booking of depreciation and cost of removal may result in swings from one year to the next from a positive cost of removal to a positive salvage gain. Methods would also be available to modify current booking in view of this concern. Notably, in Pennsylvania salvage is calculated by using a five-year trailing average for ratemaking purposes in order to reflect current salvage experience. Some similar method may be employed by the Commission.

For all of the reasons indicated above, SCA advocate that the current booking of salvage and cost of removal is appropriate. In particular, this change would provide the carriers incentives for maximizing the value of salvage and minimizing cost of removal. In any event, a large part of the current depreciation process could be eliminated in this manner.

V. CONCLUSION

SCA submit that the FCC should not approve Options Two, Three and Four and should act cautiously in adopting Option One. SCA stress that it would not be in the public interest to allow Price Cap Carriers to determine their own depreciation rates. SCA request that whatever action is taken should be consistent with the comments herein.

Respectfully submitted,

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